Rawflin Bezerra

A CASE STUDY IN

Gray Markets

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A case study in Gray Markets

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SUMARY

ABSTRACT

This work is based on a dissertation completed in the late 90s on the emergence of international gray markets, their impact on manufacturers and other members of the marketing channel and the strategies used by some companies when dealing with the gray market problem (therefore, it is important to note that the facts and figures used in this study do not necessarily apply to more current studies on the "gray market" topic). The study uses the case of a sophisticated, high-technology firm that manufactures consumer products and packaged goods as the focus of the research. First, some examples describing the general gray market problem and assess a description of gray schemes in the consumer goods industry. Then some issues in pricing schemes used by companies dealing with gray markets are approached and the status of the legal aspects referring to gray markets is described. Then I make the appropriate links of the literature review to the firm studied in this case. In this work, the firm in the case study will be referred to as TechDisk. I characterize the nature of gray markets for TechDisk and show the major issues that the firm faces when dealing with gray markets. Finally, a conclusion on the behavior of companies facing gray markets is drawn based upon the observations collected from the literature and based on the data from TechDisk.

INTRODUCTION

Gray markets have not been a major issue for academic research studies since some years ago. There is no consensus on the forces that lead to their emergence, on the impacts of these activities on the final consumer, on the losses in the distribution channel, or what should be done to control them, if at all they should be controlled. Previous studies were done relating the gray market problem to pricing strategies and exchange rate differences, and some case studies focused largely on problems in the consumer goods industry and in the computer industry. However, the increasing number of cases that have been appearing in the newspapers lately and the explicit concern of companies with gray markets have prompted more research on this subject. The motivation for the increasing interest in gray market issues is directly related to the expanding influence of gray markets in organizations' strategies. The results of the traditional approach (legal actions) companies adopted to solve the problem, have shown to managers and academia the necessity to draw a more profound study of the problem.

I start this study with the Characterization of Gray Markets. In Chapter I, I provide a description of gray markets, explain the motivation for the study, and localize the context of the study to the consumer goods industry. I explain what the gray market is, and how it works, in a more academic view, by referring to some theories that are often debated. Based on these theories, I approach the essential requisites for the existence of gray markets. Finally, in that chapter, I explain my assessment of the mechanics of gray markets, giving hypothetical examples of the gray market scheme to give a more practical view.

In Chapter 2, I approach the Impacts of Gray Markets in Some Organizations. In that chapter, I give a more microeconomic view of gray markets and focus the study on international organizations. I build the link from companies' strategies and practices, specifically the pricing strategies, to the operations of gray markets. I start with a description of global pricing strategies and explore the influence of the companies' pricing flexibility on their strategies for dealing with gray markets. I provide an assessment of companies' international pricing issues and how it affects the arbitrage phenomenon. Then I explore some of the techniques that companies use to set international prices and how those techniques relate to gray markets. I finally report some methodologies companies use to combat the gray market, as well as the legal aspects involved in the problem.

In Chapter 3, I describe the TechDisk case. I start with a company overview and situate the gray market problem in the company. A brief history of the problem is presented and an explanation of the impacts and consequences on TechDisk's strategies is provided. Then I explain how the gray market scheme operates in TechDisk. I provide information, using my assessment, about the sources and destinations of gray products. I also explore the organizational and the managerial factors that have empirical correlation with gray markets. I finally relate how TechDisk has been reacting to gray markets.

In Chapter 4, I draw my conclusion about gray markets in global organizations, by making some links from the theory of gray markets to the TechDisk reality.

CHAPTER 1

CHARACTERIZATION OF GRAY MARKETS

In this chapter, I provide a description of the gray markets, explaining the motivation for the study and localizing the context of the study in the consumer goods industry. I start explaining what the gray market is providing some definitions that are common to the literature on the subject. Then I give a general assessment of how the gray market works by providing several theories such as the “free riding” and the “consumer information”, which have been some of the most frequently debated theories in the literature to explain the gray market phenomenon. Based on these theories, I approach the essential requisites for the existence of gray markets. Finally, in this chapter, I explain my assessment of the mechanics of gray markets using hypothetical examples of the gray market scheme.

WHAT IS THE GRAY MARKET?

Gray market products, also known as parallel imports products, are genuine branded goods that are imported into a country without the trademark owner’s or the manufacturer’s authorization in that country. Made on the same production lines as authorized imports they are distinct from illegally fabricated products, or black-market products. Their only differences from the authorized products are the price and the channel of distribution. The unauthorized goods do not bear the high costs incurred with establishing goodwill in that country, such as advertising, service/repair, and accessory sales, and reduce the firms’ ability to price discriminate. Consequently, the unauthorized goods can be sold more cheaply than the authorized goods, and enjoy the “free riding"[1] on the services provided by the higher-priced full-service authorized distributors, such as advertisement.

Gray market activity can be found in everyday commercial transactions in almost any part of the world. A consumer looking to buy her favorite imported perfume doesn’t go to the fancy department store but goes to the lesser prestige local supermarket and gets it with a substantial discount, although the supermarket is not an authorized distributor. A family on vacation in Miami, willing to buy a pack of photograph film, gets it in the nearest drugstore, and pays much less for the film that comes in a package containing the instructions in a foreign language. A customer wants a classic Rolex that retails for $ 5,600 at a well-known chain of watch shops, however, at an outfit store the same watch goes for $ 4,075. In Japan, U.S. automakers have been struggling to sell luxury cars, because Japanese consumers insist on buying an American vehicle (the Astro van) that has more than 80% of its sales attributed to a network of independent unauthorized importers, where prices are

1. We approach the “free-riding” phenomenon later in this study.

substantially cheaper.

Examples from the service industry are not usual but have recently occupied space in the news. In 1995 Forbes magazine identified the gray market for U.S. satellite television services, in which the supply of small satellite dishes allowed Canadian residents - estimated now at more than 100,000 Canadian households - to watch banned U.S. channels like HBO and ESPN. The competition from the gray market was so intense that it led to the collapse of Power DirecTV, a venture aimed at recapturing satellite television viewers. With Power DirecTV now out of the picture, “the gray market should continue to flourish”, says Forbes[2].

Journal reports indicate that the focus of the gray market activity lies within a relative growing number of branded products. In the US, parallel importation is mostly active in the following product categories: Luxury European cars, Jewelry, Electronics and Computers, Perfume, Watches, Liquor, Wine and Champagne, Cameras, Film, Crystal ware, Ski equipment, Tractors, Batteries, Drugs, Tires and Construction equipment. An estimated $7-10 billion worth of products are sold every year in the United States outside the manufacturers distribution channels[3]. As an example, industry experts estimate that 10% of IBM’s PC sales, 20% of Sharp electronics copier sales and perhaps 10% of all products in the $3 billion retail salon haircare category gets illegally distributed through unauthorized channels such as food, drug and mass outlets, where they are typically sold at lower prices.

Although gray markets activities have been observed in the U.S. for some time (reports from the U.S. Commerce Department address gray markets early stages to the 1980s), there is not much literature addressing this problem at a theoretical level. There are, however, many popular impressions of the influence of gray market in companies. For example, a search in the ABI/Inform database in January 1998 using the keywords “gray market” produced 205 articles published in diverse business periodicals, most of them were small notes reporting cases of parallel import in many different industries.

The interests companies have in protecting themselves from the parallel importation of genuine trademark goods into the US are considerable. Gray markets cause companies to lose control over their schemes of distribution. The unexpected flooding of one particular market with excessive product can result in an imbalance of a company´s projections of product supply and demand, thus leading to inventory growth, increased costs, and decreased sales. In addition, gray markets cause significant losses in profits for the subsidiaries and distributors of foreign companies therefore creating, among other tensions, tremendous strain on corporate relationships with such parties.

Moreover, gray market goods can generate negative impacts on the goodwill of trademarks, as well as on the reputation of the manufacturer and/or the distributor, if, for example, products that not specifically tailored to the US consumers are imported and sold

2. Forbes Magazine (l996)

3. Cespedes, Corey and Rangan (1988) and Business Week, April 15, 1985.

in the US or if products that have a price based on a “prestige appeal” are sold at a lower price. An interesting issue may arise if the gray product does not fulfill all of the safety requirements demanded by the destination country regulation. This could be caused by the less severe regulation of the source country. If an accident occurs involving the gray product, the manufacturer may be liable.

Sources for gray market products are derived from local and international manufacturers and distribution channels. In this study, the regional gray market activity is not assessed. Our focus in this study is the international gray market and its impacts in the U.S. market. Additionally, some manufacturers use a “dual distribution” structure for their products, utilizing both direct sales to the customers and indirect sales via authorized distributors. We are not addressing the direct sales problem in this study. We are focusing the discussion on the specific indirect distribution system. Our objective in this study is to understand the sources of gray products, the effects on organizations, and the appropriate manufacturer policy towards gray markets in the consumer goods industry.

HOW THE GRAY MARKET WORKS

Gray marketing occurs where one or more distributors possess the exclusive right to sell a certain product designated by a trademark in a certain area, and other distributors (unauthorized) sell similar products in that area under the same trademark. These similar products may not carry full warranties or may have different packaging, but unlike traditional trademark infringement, products sold through these unauthorized channels are made by the original manufacturer and stamped with the trademark owner’s approval. As long as there are price differentials large enough to support the costs of shipping and commercializing the products in a foreign market, and still generate an attractive return, gray marketers are likely to continue to take advantage of the gap between supply and demand.

A simple view of gray markets is that they are almost inevitable when the manufacturer of a branded product limits distribution to a set of high service dealers. Gray market in this case reflects the market reaction to factors that are inherent in a reputable manufacturer channel strategy[4]. These factors are the choice of a high service channel by the manufacturer to serve the majority of the consumer’s needs, and the decision to avoid general relationship to low service channels because of the desire to maintain a high service image. The manufacturer limits distribution and requires the authorized resellers to provide services. These high service channels have higher prices. Consumers that do not value services sufficiently to pay these prices will provide the demand for cheaper low services products.

In general, there is much controversy regarding the circumstances that foster the

4. Banerji (1990)

emergence of gray markets. The economic analysis in exploring the background of parallel importation gives rise to many economic situations involving gray market activity. Among many theories for gray markets, I will shortly explore three explanations, which come from recent theories called respectively “free-riding”, “consumer information”, and “distribution efficiencies”. The “price discrimination” theory will be explored as well, later in Chapter 2 as part of the study of the overall pricing strategy of the firm.

The “free-riding” effect problem has been cited in the discussion of vertical restrictions, and it was developed by Telser (1960) as an explanation for resale price maintenance. Economic and marketing books commonly use the term “free-riding” to describe the behavior of distributors and dealers who offer extremely low prices but little service to customers[5]. The idea is that the discounter gets a “free-ride” from the services provided by the higher-priced full-service provider (distributors and dealers). Some of these services may include investments in advertisement, customer education on the product, customer service, warranty, and personal training. These full-service providers have the power to certify the product quality and therefore are investing to establish a manufacturer’s brand. If the low service provider can have access to the same product at a resale price, they can charge the high prices used by the high service provider. Consequently, a low-price reseller’s incentive to appropriate gains generated by some other agent’s effort or investment may cause gray markets to emerge. As a result, less distributors will be willing to invest in services provision.

One important characteristic of this theory is the possibility for consumers, who do not value the services provided by the authorized reseller, to unbundle the augmented product. This means that free-riding is only possible if the services that are provided by resellers can be dissociated from the products. This is especially important for products that bundle presale services, such as education about the product or assistance for selection and purchase, which are potentially more subject to free riding.

In the case of free riding on the after-sale service, the service must be provided by the distributor and not by the manufacturer. In addition, it is necessary that the authorized distributor unbundles the services with the goods and sells them as one package with one price. Moreover, the services must be commoditized in such a way that the consumer is able to obtain the services not only from the same distributor who sold the product but also from many different distributors. Otherwise, consumers who do not value the services bundled with the goods will not be able to purchase the product in a discount store and obtain after-sale services freely from the authorized distributor.

Another theory less debated but as important as the free riding theory, is the “consumer information” theory. It states that consumers who are less informed about a full service bundled product, although they value services, tend to be attracted by the low-price resellers. This phenomenon, by theory, will generate demand for gray products. However,

5. Rosembloom, Marketing Channels (I995)

this sale of a low-price product without value addition assumes an extraordinary deficiency of the information channels and a constant status of lack of knowledge about the product on the part of consumers. Critics of this theory find hard to accept this lack of information for novice consumers in high scale, due to the availability of many different channels for communication of a product features and services included.

Several writers on parallel importation have argued, either expressively or implicitly, that parallel importers are more efficient than authorized distributors. Therefore, the parallel importer has an incentive to undertake parallel importation and has the ability to compete with the authorized distributors[6]. To complement those arguments, the theory of "distribution inefficiency" supported by Hilke (1988) and Staff (1989) may explain some cases of parallel import. They assume that some retailers or wholesalers may be more efficient in carrying out some distribution functions that are usually provided by the manufacturers or their authorized distributors. A profit maximizing manufacturer would offer such an efficient retailer a discount if the retailer would undertake these distributional functions.

However, such a discount offer will not always be available, which will give the retailer the incentive to take advantage of its efficiency through parallel importation offering the products at lower prices. According to Hilke (1998), manufacturers cannot offer the discounts due to contractual restrictions or since conflict with their selective distribution or with the legislation against price discrimination needs to be avoided.

The focus in this study is not questioning the validity of these theories, nor is it evaluating models that confirm or refute their statements. As mentioned before, the issue of gray markets has not been covered extensively in the marketing or economics literature. One might affirm that no single explanation is consistent with all the gray market characteristics and that gray markets are consequence of the interaction of many of the cited reasons.

Requisites for Gray Markets

It was explained that the theories of "free riding", "consumer information" and "distribution inefficiency" do not completely explain the occurrence of gray markets. However, in general, most of the literature agrees that International Price Differentials, Sources of Supply, and Trade Barriers can be considered essential prerequisites to the evolution of gray markets. I now describe these requisites.

International Price Differentials

Gray markets are induced by the commercial availability of similar goods in different countries at significantly disparate prices. The manufacturer's pricing policy is extremely relevant in understanding the channel participant incentive to engage in the gray market. It is believed that large price differentials between countries or between resellers for the

6. Rubin (1993)

same product generate the opportunity for parallel commercialization of this product. The manufacturer's ability to effectively monitor and quickly respond to price differentials can stop the gray market activity at its early stages. Of course, this means a reduction in the manufacturer's ability to price discriminate.

International price differentials can be a consequence of a company pricing policy. A manufacturer who supplies two markets with the same product may decide to charge different prices in order to face the competition prices, or to acquire some market power, or to drive the competition out of the market. In the last two cases, the differentiation in prices is a short-run technique, and it is sometimes called "predatory pricing" [7] (from the predator's point of view, acquiring market power is just the first step towards the monopolistic pricing level). In addition, pricing policies can lead to international price differentials when companies identify different elasticities of demand in different markets. In order to maximize profits, companies charge the highest price in the market that has the lowest demand elasticity at the simple monopoly price.

Different pricing policies also can arise as a function of the company's market power. Markets that are perfectly competitive will bring, in the long run, a competitive equilibrium price. Markets where companies possess some kind of market power, such as the support of a strong brand or the protection of trade restrictions in the local market, allow these companies to control the pricing discrimination of their products more effectively.

The discrepancies in prices are in many cases the result of currency fluctuations. Parallel import was escribed as a phenomenon of the 1980s that arose simultaneously with the rapid appreciation of the U.S. dollar. Some manufacturers are reluctant to adjust the price of their imported products when exchange rates variations occur. According to Krugman[8], companies "price to market" - or maintain the export prices of their goods when the local currency of this country rises - when the manufacturer is influenced by its belief that the exchange rate variations are temporary, and the consequent demand adjustment lag is short. Alternatively, they price to market when the manufacturer has limitations in distribution and capacity infrastructure to expand production and meet the expanded demand. Yet another explanation for pricing to market bases on the manufacturers' concern about their products' reputation. In such cases, the manufacturer maintains the original products' prices to preserve the consumers' perception of the brand.

Prices differentials influence on the level of intensity of gray markets can be enormous. For example, an estimation from Dolan and Simon (1996) showed that if the differential between the German and the U.S. prices for a specific pharmaceutical product would be 57%, then about 32% of the sales volume of that product in Germany would be served through gray market imports from the U.S.

7 Dolan and Simon, Power Pricing (1996)
8 Krugman (1987)

Sources of Supply

For a gray market to exist, gray marketers must resell the manufacturer's product. As this reseller is not authorized to resell the product and therefore cannot buy directly from the manufacturer, the only source of supply is the set of authorized resellers. Sources of supply may be the most essential prerequisite for the gray market activity. In order to indirectly participate in the distribution channel for any product, the unauthorized distributor or retailer must penetrate the official chain and have access to the inventory available in order to supply the additional quantities demanded by gray markets.

Trade Barriers

Many gray market imports to the U.S. come from countries other than where they were originally manufactured. Trade barriers between countries must be low enough to provide easy access from one market to another. Nowadays companies have access to many world markets. However, the globalization of markets has made it more difficult for companies to control the flow of products to and from different markets. Additionally, it has increased the complexity of setting prices to heterogeneous international markets.

Trade barriers can influence a structure of a market and the pricing policy of a firm. Market structures are strongly influenced by the trade barriers that governments impose on the open portion of their economies. Typically, these barriers restrict competition from foreign sources. As a result, the competitive structure of an industry is altered. Existing market participants gain greater control over the market, which can result in more discretion in a firm's pricing policy. Consequently, trade barriers can contribute to a company's price discrimination policy. Countries that have a strong trade restriction to foreign products, such as quotas or import restrictions, permit companies to have some control over the prices of its goods in the export market[9]. Even if the demand become more elastic, the manufacturer may not have to lower its price, since quotas prevent increasing supply to meet the demand. An example of this effect is the automobile industry in the early 1980s and the Japanese experience with import quotas[10]. For car manufacturers like Honda, the attractiveness of its product and the restricted supply to U.S. consumers meant that it had a large degree of pricing flexibility, and in fact it was able to maintain large margins.

Until now, we have seen that International Price Differentials, Sources of Supply and Trade Barriers have strong influence over the rise of gray markets. Except for the sources of supply, a manufacturer has almost no power to influence changes in these requisites. Does it mean that gray markets are basically a macroeconomic problem? Not exactly. As we shall see, the microeconomic management of the problem is as important as the macroeconomic

9. Staff (1987)
10. Bell (1987)

view.

In addition to the requisites cited, five factors that are highly dependent on the manufacturer's management policy can influence the degree to which gray markets arise in organizations: Brand, Selective Distribution, Discount Policy, Management Concern, and Manufacturer Information System.

Brand

Gray markets affect credited manufacturers and occur in branded products that hardly have any substitutes. Journal reports indicate that manufacturers that have a strong brand and market presence are more susceptible to gray market activities[11]. Products from these manufacturers are promoted with substantial advertising and promotional services, which give rise to consumers' extra willingness to pay for them. Foreign manufacturers tend to put a great deal of emphasis on their reputations so that many of them tend to exclude mass merchandisers and discounters from their authorized distribution channels.

Selective Distribution

Manufacturers of branded products tend to choose a selective distribution and authorized reseller structure. One reason for this is the aspiration of manufacturers to maintain the brand recognition and the status of accessibility for the product (the "prestige appeal"). The decision to distribute a product by a distinct channel may be a signal to consumers of the quality of the product and can help establish a manufacturer's reputation. However, selective distribution creates a gap between actual consumers and potential consumers. These potential consumers usually do not value the augmented product (and therefore do not want to pay for the services bundled) or do not have access to the formal channels of distribution. The latter customers will become the marginal demand that will be supplied by the gray market.

Intel is a good example of how distribution fosters gray markets. Despite the chipmaker best efforts, chronic shortages of Pentium Pro chips continue to disrupt the channel, frustrating distributors and vendors[12]. Only a portion of 200MHz Pentium Pro chips produced is flowing through Intel-authorized chip distributors, and as a result, driving the price up and creating the attractiveness to gray market. Some distributors say that they have been "forced to use the gray market to meet our orders for Pentium Pro". Non-authorized distributors see their business as independent distributors playing a pivotal role in transforming the way the industry does business, providing a needed service to the channel.

In the Intel case, lower-than-expected demand or faulty forecasting results in excess

11. Banerji (1990)
12. Computer Reseller News January 27, 1997

inventory. Those chips enter the gray market when they are sold to independent distributors who resell them. Some OEMs and distributors can sell chips at cost and still turn a profit when they take advantage of special rebate deals for high-volume customers, such as credit and co-marketing funds from Intel. Adding to the vitality of the market is the ease with which chips are transported. A standard container of microprocessors from Intel is usually a small size box.

Another reason for companies to select distribution is to exploit the market power they have (especially for branded goods). By controlling the quantity sold through the distribution channels, a company can act as a monopolist and more fully take advantage of whatever market power it has.

Discount Policy

When selling to intermediaries, some manufacturers use quantity dependent pricing schemes. Especially for products where there are large scale economies and significant learning-curve effects, large orders are very attractive to vendors, despite the quantity discounts involved. Manufacturers that use discounts as an incentive to increase their sales are more exposed to the origination and growth of gray markets.

These quantity-based discounts provide fuel to gray markets, since they exacerbate the incentives of authorized dealers to resell to the gray markets. Manufacturers wholesale pricing schemes do not directly promote price differentials because retail pricing and service strategies are usually controlled in the retail level. However, resellers will be tempted to increase their orders to apply for the discounts, and consequently will generate excess inventory that can be divested to the parallel commercialization in other markets.

Management Concern

Substantial organizational difficulties are involved in achieving cooperation among subsidiaries because of the difficulties in aligning subsidiaries' managers interest with those of the firm as a whole. The level to which the manufacturer is committed to constrain the activity of gray market, as opposed to the commitment to the volume sales (and revenues expansion), can affect the encouragement the resellers will have when deciding whether to redirect product sales to unauthorized channels. It is a matter of credibility of the manufacturer's policy.

Some studies support those gray markets represent a trade-off between gains and losses for the manufacturer. The manufacturer may have some incentives to permit a gray market to exist[13] since it provides the manufacturer the ability to perform price discrimination between consumers. Therefore, the manufacturer can sell its products to a different type

13. Banerji (I 990)

of consumer, who has low valuations for services, and otherwise is lost. Hence, resale restrictions may be applied to regulate the gray market's size, and not to completely eliminate the gray market. In such cases, the deterrence policy a manufacturer uses reflects the choice to terminate resellers only when the violations are extremely harmful to the manufacturer. Usually, the penalty policy applied to those cases reflect both the violation size and the characteristics of the reseller such as tradition and size. In some cases, the manufacturer management is not initially overly concerned with the gray markets due to the initial small number of sales being divested in that manner. In addition, some managers accept the gray marketer performance as an indirect service by acting as a kind of "second source" of supply at some smaller sales accounts.

One important aspect of the management concern is the criteria used to judge management decision. In a multinational environment, the results-based incentives applied to the different markets goals directly impact how managers react to the gray market problem. In the same organization, management indifference to gray markets can lead subsidiaries to become competitors. As an example, gray markets can create havoc within the organization if managers from country A are rewarded for increases in sales and achievement of their goals, while managers from country B might be penalized for the less outstanding results as a consequence of the parallel imports from Country A.

Manufacturer Information System

Lack of reliable information on the sources and destinies of gray products seems to be a major barrier to effective responses from manufacturers to gray marketers. The manufacturer efficiency in controlling and tracking divested products can provide the information necessary to apply the penalties to the unauthorized reseller and help implement actions to prevent new attempts. Additionally, given the costs of detecting violations and assessing penalties, efficient information systems that can monitor price differentials can help manufacturers to plan in advance to prevent leakage in their distribution system and potential entrants into the gray market activity.

Consequently, manufacturers that are efficient in monitoring potential gray markets signs can structure incentives programs to encourage compliance of their resellers with the existing distribution contracts.

The Mechanics of Gray Markets

So far, I have described the gray markets and have assessed the essential conditions for the emergence of gray markets. Now a description of the mechanics of the gray market dynamics, characterizing some of the activities that take part in the process, is provided. A hypothetical example is used, illustrated with a scheme of parallel imports.

In international gray markets, the importation is parallel in the sense that there are

two parallel streams of commercialization to foreign countries: one authorized and other unauthorized. In addition, in some cases, the trademark licensee is not importing the products, but rather manufacturing them in the country where the product will be distributed. It is important to emphasize that it is hard to find evidence of the scheme adopted by parallel importation. The agents involved want to protect the identity of their sources of gray products and do not want to draw the attention of authorized distributors.

To assess the mechanics of the parallel import, we consider three economic agents in the basic model (see Fig. 1): a domestic authorized distributor (authorized importer), a gray marketer importer/exporter, and a manufacturer. We are assuming that the domestic authorized distributor provides advertising and promotional services with its own financing, since usually the manufacturer has very high costs in providing services directly to the consumer. Additionally, we are assuming that the authorized distributor provides more intensive advertising and services than those distributors of the manufacturer country. Moreover, authorized distributors cannot charge separately for the services provided.

The original manufacturer is usually a producer of recognized brand goods. In addition, in some cases, the manufacturer has facilities in the target country of the gray goods. This original owner of the trademark distributes the products to the international markets through different kinds of distributorship arrangements. The authorized distributor is usually a domestic company that has a contract with the manufacturer and purchases products according to that contract, which may include some services requirements. The gray market importer/exporter can be any company that participates in the international distribution structure of the manufacturer. It can be an authorized distributor or a retailer in another country that exports to the target country, or it can be a domestic authorized dealer that imports from foreign countries.

A typical situation arises when the manufacturer is also the supplier of gray goods. Such cases may signify that the manufacturer does not know the identity of their customers and is supplying the goods without knowledge of whom the final buyer in the supply chain is. Another reason is that the manufacturer is indifferent to the effects of parallel importation and is taking advantage of that parallel channel to increase sales.

In the U.S. case, the relatively higher distribution costs the authorized distributor bears make it profitable for the gray market importer to obtain the products at a lower. The importer buys them from international authorized distributors or resellers and benefits from the extra promotional efforts financed by the authorized importer (see Fig. 1).

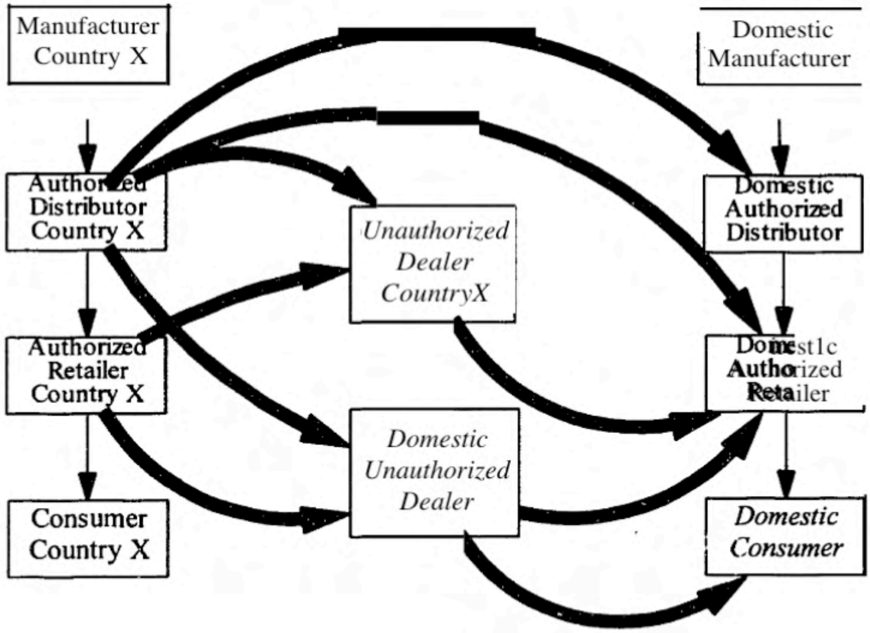


Fig 1. International Gray Markets Basic Scheme

Global companies develop products for the global market, capitalizing on and exploiting many of the benefits of international product and brand uniformity. Usually, the same global market segment is targeted in all countries the company has operations. Only the sizes of the segment may vary from country to country, depending on demography, income, and cultural and social factors. The result is an international product line that can be found in all stores.

Additionally, to protect the exclusivity of their products, as part of their marketing strategy, some manufacturers seek to limit distribution channels. One reason may be that by limiting the number of places to buy a product, the manufacturer also maintains profit margins for the supply chain. Another reason to limit supplies through limited outlets is the creation of an artificial value for the product, which allows for the markup being charged by authorized dealers1[14].

To explain the scheme from Fig. 1, a Swiss watch maker A that has developed and is marketing a new model of watch in global markets is taken as an example. This manufacturer authorizes dealers. Authorization is accompanied by various trademark and reputation protecting provisions. Resellers are required to provide services, and the manufacturer does specify some investments to ensure the provision of services, meaning that authorization serves as service guaranteeing signal to consumers. Pricing to dealers follows an all-units

14. Journal of Lending & Credit Risk Management October 1996

discount scheme. Resellers are prohibited from horizontal resale to resellers.

In the U.S., the watch manufacturer's practice is to control distribution by selling the watch strictly through its chain of distributors. The distributors, to maintain the value of exclusivity incorporated in the product, limit sales to the consumer through selected high price retail outlets. At the same time, outside the U.S., in Asia for example, the watch manufacturer is selling the new watch to a vastly different clientele. Manufacturers are eager to sell to these markets because of the additional volume they create. Often, to meet minimum order requirements or as a result of the differences in negotiating power from each side, they sell amounts of the watch into these markets that far exceed the actual demand for the product. These buyers (Asian distributors), therefore, have stocks of watches for which they have paid and must in turn sell to recoup their investment.

These Asian distributors have developed a relationship with a gray marketer in the U.S. that has taken excess supplies from them in the past. The suppliers contact potential buyers at trade fairs after they hear the latter might be on the lookout. Buyers get a few samples and then buy the whole container. After negotiating a mutually advantageous price, always below the distribution price in the U.S., this intermediary distributor is able to resell the watch shipment to the retail dealer at a price considerably lower than the official distribution price. Consequently, a consumer in the U.S. can buy the Swiss watch originally manufactured for distribution in Asia for a bargain.

On the marketers' point of view, they claim that some watchmakers are willing to sell to them directly. Most gray-market goods come from authorized dealers who unload excess inventory on discounters. The supposed reason for that is that the dealers make a nice profit without any risk and compensate for the capital they have spent buying watches from the manufacturers. Other examples of such scheme are found in medical products industry, where a common source of gray product is in goods intended for export. Despite the large discounts granted the large hospitals and groups, many manufacturers offer even lower prices to foreign buyers, creating the opportunity for parallel commercialization.

Gray marketers may adopt a dubious practice in order to have access to authorized distribution channels. For example, in the computer chip market, some unauthorized distributors operate under the pretense of being a systems manufacturer, by buying chips in bulk and quickly divesting purchases domestically or overseas.

SUMMARY OF CHAPTER 1

In this chapter, I attempted to describe and characterize gray markets. The reader has seen that gray markets occur when genuine trademark goods are imported into a country without the trademark owner's authorization. The major problems with parallel importation are the strains and losses in profits that it causes to the manufacturer's distribution systems

and the negative impacts to the goodwill of trademarks. In addition, I presented some requisites that foster the existence of gray markets, and the reader also could observe a simple view of the gray market schemes in international markets. In chapter 2, the reader will better understand why firms are concerned about gray markets and how those firms manage to deal with them.

CHAPTER 2

IMPACTS OF GRAY MARKETS IN SOME ORGANIZATIONS

Until now, the reader has seen the basic explanations for the emergence of gray markets. In this chapter, I explore a more microeconomic view of the impacts of gray markets in some organizations. I provide an assessment of global pricing strategies and their importance in companies' strategic planning to reduce the impacts of gray markets in their businesses. I then bring some examples of how companies might react to gray markets activities. Finally, I describe the overall status of the legal aspects related to gray markets.

Global companies are offering more interdependent products for more interdependent prices. Today it is almost impossible to separate markets and products individually and determine prices for each constituent independently. As products are standardized across the world and global brands are dominant, treating products prices individually increases the risks of losing worldwide profitability when gray markets are potential players. In this world of global markets with differences in the consumers' needs, companies deal with the dilemma of differentiating their products prices while trying to avoid the consequences that price differentials can bring along, such as gray markets.

GLOBAL PRICING STRATEGIES

One popular reaction of companies to gray markets is to implement changes in their pricing policies. One reason for that preference can be explained by the low inertia that changes in prices have over the distribution chain. Changes in prices are rapidly spread among distribution channels, and the effects of each decision in pricing issues are perceived faster by the organization than when other methods are used.

The influence of prices over gray markets has been tracked for some time. Reports from the U.S. Commerce Department in 1985 indicated that in the U.S., for some industries, retail prices of gray market imports were up to 40 percent cheaper than those of trademarked products[15]. The survey showed that the gray market charges less because it imported products at lower wholesale prices from overseas, and because it placed a lower markup on the products due to lower overhead costs. Furthermore, the reports showed that retail prices are lower in cities and regions with gray market import competition.

Companies' responses to differences in price depend on the companies' pricing strategies. Traditional firm's general options for setting prices are mainly the cost plus

15. Hilke (1987)

method, the matching competition method, and the market determined pricing. The cost-plus method consists of firms determining unit costs and applying a markup to yield price. Matching competition consists of firms setting its prices according to the competition prices positioning and how the customers see the firm's products related to the products it most directly competes with. Charging what the market bears, or the market pricing, is used when the firm has a monopoly or a monopoly-like power.

Each pricing option depends on the firm's positioning in the market. The cost-plus method, for example, has some advantages, such as simplicity and easy to apply and can lead to optimal pricing if competitors' behavior is similar in terms of pricing structure and apply similar markup. On the other hand, this method does not consider the demand side and the customer willingness to pay those costs.

The best pricing strategy open to a firm is function of the microeconomics conditions facing its business. For example, firms in a competitive market are price takers, while monopolies can maximize profits by trading off on price or quantity subject to their demand curve or oligopolies must consider rival firms' behavior in determining its own policy. Charging what the market will bear can be the most lucrative of the above options. However, in order to take advantage of the market willingness to pay the prices, a firm must have market power or establish a position in a less competitive industry niche. Product differentiation, segmentation of the market, quality, are some of the additional means for firms to achieve market power.

We divide our review of pricing strategies in two aspects within a company point of view: the pricing flexibility and the price discrimination, since we consider these aspects the foundations for defining the pricing strategies for positioning of the company in the market.

Price Flexibility

A firm's pricing strategy is directly correlated to its pricing flexibility. The pricing flexibility of a firm is determined by the market economic environment, the characteristics of the industry and the firm's specific factors [16]. Previous studies have examined the determinants of corporations' abilities to change their local currency product prices when scenarios change. Factors that influence the price flexibility of a firm, in such cases, were price territory, firm integration, organizational structure, and exchange rates volatility, among others.

The prices territories effect

A fundamental determinant of industry structure and the degree of pricing flexibility of individual firms depend on whether prices are determined locally or globally. Local prices are determined by conditions in the local market and are not affected by changes in other

16. Bell (1987)

foreign markets. In contrast, international prices are determined in a world market basis and one price, net of trade barriers costs and transportation costs, applies for the product across all markets. In this case, supply and demand from all the local markets determine the global price.

The pricing flexibility of firms whose product markets have their prices determined locally is in general higher than firms with globally determined prices. In a market with locally determined prices, it is much easier for a firm to exercise its market power and set prices. On the other hand, firms with globally determined pricing strategies have little market influence to dictate prices, and since the changes in exchange rates will not affect all the competing firms to the same degree, some firms will be banned more by their inability to pass-through exchange rates changes.

As I mentioned before, a firm's pricing strategy is directly correlated to the firm's flexibility to change prices. Now I discuss about the factors that influence the firm' s pricing flexibility.

The vertical integration effect

The level of vertical integration that characterizes the industry as a whole, or the dominant market participants, affects market structure and its impacts in pricing flexibility. An industry in which extensive vertical integration is the norm may have less pricing flexibility because of locked-in sourcing costs. If firms are vertically integrated domestically, which essentially means that costs are in their domestic currency, pricing flexibility is restricted. If firms are vertically integrated but diversified across countries, then some price flexibility will exist. Firms that are not vertically integrated will have more flexibility in their costs since they can alter the sources of their inputs and they are more exposed to market prices information.

The organizational structure effect

The way a firm is organized in its marketing, sales and distribution will affect its pricing flexibility. The organizational structure of a firm will determine with whom and where the pricing decision making ability resides. Firms that are highly centralized tend to price in individual markets with the overall firm profit maximization in mind. They adopt a more global pricing strategy and less local price decisions. Such criteria might result in a price response other than that which the market would determine.

The exchange rate effect

Fluctuations in exchange rates are a serious issue in international pricing. They can suddenly change competitive price position. The high level of exchange rate volatility has

made corporations sensitive to the effects of exchange rates on their operations. Dramatic changes in exchange rates have put tremendous pressure on profits and on the ability of corporations to adjust the prices of their products. Moreover, exchange rates volatility reduces the corporation's ability to respond to the changing patterns of competition in the open portion of their domestic and foreign market. Bell[17] studied the influence of external factors and internal characteristics of the firm as the critical dimensions of the firm's "pass-through" (or how much the firm can apply currency changes to the prices of products) ability under real exchange rate changes. However, the consequences of a pass-through strategy in the presence of gray markets have not been completely explored yet.

"Pass-through" is a complex issue for companies. Consider international companies that have their production costs based on dollars (production facilities are located in the U.S. and supplies are dollar-based, for example). The availability of alternatives when dealing with exchange rate fluctuations leaves the company with three options. As the dollar appreciates, the per unit profit declines if the company decides to maintain the price in the local currency. This means that, in dollars, the product price is lower, and the company's margins are lower. This is observable since the costs of the products are expensed in dollars, not in the local currency. Now consider the option that the company raises the price in the local currency as an answer to the dollar appreciation. Microeconomics theory has shown that for an elastic demand, prices increase would result in less volume of units sold. Since the customers' price response is determined by the price they have to pay in their own currency, the company suffers losses in sales volume.

Both previous options are extreme reactions to the changes in the exchange rates. The company either absorbs the full difference in price or the burden is fully passed through to the customers. A third option, however, may reduce the impacts of changes in the exchange rates in the company's profits. The company can implement a moderate price increase[18]. In this option, the differences on prices are absorbed by both the company and the customer. Naturally, the company will miss some profits via reduction of margins and lower volume sales (we are assuming that demand is price sensitive). However, the case is clearly not to maximize profits but to reduce losses. If the company maintains the price in the local currency, it can result in losses in margins. If the company raises the price, following the appreciation of the dollar, lower sales volume can be expected. Consequently, the moderate price increase can be the best solution to reduce the losses. Of course, before deciding price changes, and in addition to the customers' response, the company has to evaluate the competition responses to any prices' changes. This is why international pricing is such a complex issue.

17. Bell (1987)
18. Dolan and Simon (1996)

Price Discrimination, International Pricing, and Arbitrage

This part of the study illustrates the impacts of global pricing strategies in the emergence of gray markets. We have seen that international pricing is not a simple task for managers of global companies. We have also seen that pricing strategies rely on the company's pricing flexibility and in the ability of the company to price discriminate. I now approach the relation of price discrimination in international markets. In addition, the arbitrage phenomenon and its relation to gray markets is described.

One reason for price differentials is that some firms have market power and would like to price discriminate by charging different prices in different markets for the same product (without any true cost differential to justify the different price) to increase their profits. Most of the time these different markets are international markets. The key to performing international price discrimination is halting arbitrage[19] (buying in one market and selling in another market). As we shall see, the gray market represents the arbitraging that reduces the ability to price discriminate.

However, international pricing is a complicated matter for managers. There are many implementational difficulties. A fast response to sudden changes in exchange rates, for example, is extremely problematic to put into practice. The market positioning of a company in relation to the competitors and to the customers has to be weighted before deciding changes in prices. In some countries, low prices may be reasonable in order to keep competition in control.

Traditionally, companies want to define prices of international products by simply setting the optimal price for each individual country. As I cited before, this is called price discrimination. These different prices for different markets do not always reflect the peculiarities of each country and usually are set in a cost-plus base[20]•

Enormous price differentials already exist between countries, independent of price discrimination schemes of companies. These differentials are rooted in consumer behavior, distribution structures, varying market positions, and tax systems. Consequently, today almost every product is affected by the pressures of international price alignment.

Price discrimination always seems to offer the seller an advantage to maximize profits[21]. However, the presence of competition can constrain the ability of a company to price discriminate. If a single seller tries to price in a way to gain more than the market gains from trade, the seller may find themselves without any customer if the customers understand what is happening.

As I mentioned before, the essential condition to price discriminate is to bar arbitrage. Basically, arbitrage is the operation of buying a commodity at a certain price and then

19. Denzau (1992).

20. Dolan and Simon (1996)

21. Denzau (1992)

selling it a higher price. The key to this mechanism is the ability to resell the commodity.

With some goods, especially services, it is almost impossible for the consumer to practice arbitrage and resell. Services directly performed on the consumer cannot be resold, and price discrimination could be used in these cases, although competition still limits its extent. With commodities whose quality and value are easy for a consumer to assess (such as a branded good), reselling would be easy, and arbitrage would be common. The gray market of Rolex watches in the U.S. is an example of arbitraging between the U.S. price and the prices Rolex is charging in other countries[22].

If incomplete information about the market among buyers and sellers, transportation costs, storage costs, and government controls on buyer-seller transactions were banned from markets, arbitrage would be impossible[23]. Nevertheless, in the real world, market information is never complete or freely available. However, in many markets, some companies which are aware of the arbitrage phenomenon, keep price differences within such a narrow margin that they can be safely ignored by arbitrage players.

Pricing strategy and consequences to the gray market

We have discussed about the global pricing strategies of companies, their pricing flexibility, and their capacity to price discriminate in international markets. We saw how these aspects are related to the emergence of gray markets. Examples about how the pricing strategy of a firm brings opportunities for gray marketers to explore the differences in prices are given now. Moreover, a reference to the “price corridor” technique, which is becoming a more viable response from firms threatened by gray markets due to international price differentials, is made.

Two sources of gray products, the big resellers and the small resellers, are identified as consequence of the manufacturer’s pricing strategy to distributors. Some manufacturers use a pricing policy that is correlated with the size and prestige of the reseller. Bigger resellers have more access to price discounts since they order large quantities. On the one hand, big resellers are encouraged to increase their orders to have higher discounts. Consequently, excess products could be divested to international resellers who are willing to pay less than the prices that are offered in their countries.

Additionally, small resellers face wholesale prices that are higher than those faced by big resellers, and consequently have an incentive to lower their costs. Small resellers, then, could buy bigger quantities than they could sell in their countries at the full-service level. Having access to the bigger discounts, they could resell the extra quantities to other small international resellers at no service charge. Since some consumers are not served because the retail price is often too high for them, opportunities exist for these other small resellers to sell to these customers and extract the premium provided by the manufacturer’s

22. Denzau (1992)
23. Dewey (1975)

brand.

One other source of gray products may appear when companies' set international prices. Theoretically, the skill in pricing lies in knowing what the price elasticities in the various countries are. However, pricing in some international companies is usually decentralized and experience driven. Managers devote much more time and energy to costs than to prices, though both are equally important as profit drivers. Country specific optimal prices often become attractive for parallel deals when the difference between country prices is too large.

Several solutions are available for the latter case. The worst option, yet the easiest to do, is to let all prices slide to the lowest common denominator. An alternative is to raise prices to the highest level. As we have seen, this is usually untenable since it means giving up some of the low-price countries completely, even if the high-price country sales can overcome the relative loss of the low-price market. Therefore, a more viable solution may be the use of a "price corridor".

"Price corridor"[24] or bandwidth pricing

Similar to the "moderate price increasing" from Bell (1987), establishing a price corridor means raising some prices and lowering others in order to achieve an acceptable price bandwidth. An international price bandwidth considers both the differences between countries and rising alignment pressures. This corridor has to be determined by the company headquarters and its country subsidiaries. No country is allowed to set its price outside the corridor. Countries with lower prices have to raise them, and countries with prices above the limit have to lower them[25].

The corridor should consider market data for the individual countries, price elasticities in the countries, parallel imports resulting from price differentials, currency exchange rates, costs in countries and arbitrage costs between these countries, and data on competition and distribution. According to Dolan and Simon (1996), pricing in the bandwidth, when correctly established, can typically improve profits by 15% to 25% compared to the uniform pricing scheme. In addition, the corridor practically eliminates gray markets.

The price corridor attempts to find a compromise between warranted price customization and necessary price uniformity. Corridors require a stronger centralization of pricing competence. This runs against decentralization tendencies, but if country markets are merging, centralization is a necessary consequence. One country destroying the pricing of a whole region and profiting from this is unacceptable for the price corridor scheme.

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24. Dolan and Simon (1996)
25. Marketing News October 9, 1995

HOW COMPANIES REACT TO GRAY MARKETS

We have just seen that price corridor can be an effective response for gray markets activities, although it brings attached some adverse effects, such as the need of centralization and loss of market power to the local country management. Now some different practices that companies have traditionally used to face gray markets are presented.

A group of authors suggests some universal strategies for firms to fight gray markets. In general, these strategies rely on the premise that pricing can be controlled such as by instituting a one-price-for-all policy or an aggressive price-cutting strategy[26]. The use of "vertical restraints", that limit the ability of any reseller to cut price and take sales from reputable resellers, or that restrict authorized resellers from reselling horizontally is another solution proposed by the literature[27]. As example, Merck & Co. of the United States has tried to break through European price walls for the first time by using a one-price for all policy and fixing the same price across Europe for one of its new drugs. Merck announced in early October that it was pricing its anti-AIDS drug Crixivan at the equivalent of about $12 for a day's supply in every one of the 15 different European Union pharmaceutical markets. With an additional display of imagination, Merck chose to fix the precise price not in dollars, but in the European currency unit[28].

"Exchange-rate fluctuations and other factors can adversely affect the price, and thereby the availability, of products," the company said. That only hinted at the severe reality that faces successful medicines in Europe. Under the European Union's insistence on open internal borders, successful products will rapidly become the victims of parallel importers. By setting a single price, Merck hopes to head off some of the price differences that encourage parallel imports.

Nevertheless, in practical terms, companies always emanate some other creative solution, not always completely effective, but sometimes more applicable to their cases than as an universal solution. In the pharmaceutical industry, for example, even in regulated markets where price is controlled by the government, there are some other options used by companies. In general, managers employ strategic links between the price, the legal framework governing the marketing environment in the country, and anti-gray marketing strategies to facilitate managerial control. In such cases, the following strategies appear to be prevalent alternatives:

a. Differentiate products within the legal framework to create doubt about the authenticity of the product and possible interference with the patient-doctor relationship (which can be justified, if challenged, based on the distinct resulting therapeutic effects).

26. Journal of Health Care Marketing (Fall 1995)
27. Banerji (1990)
28. Pharmaceutical Executive (December 1996)

b. Try to include a no-export clause when manufacturing a drug under a compulsory license in a particular country so that subsequent distribution of the drug in another country can be legally prohibited.

c. Vigorously defend trademarks of pharmaceutical products by immediately instituting legal challenges to prevent third parties from marketing drugs under the same brand name in other countries. Trademark rights have greater protection because the fundamental purpose of a trademark is to ensure that the consumer knows the origin of the product. In addition, some countries have limits on parallel imports in the interest of preserving the physician-patient relationship[29].

Parallel importers take a free-ride on after-sale services by selling the products at a discount, without any warranty or maintenance service. When the parallel importer's customers buy the product, they count on the availability of the authorized distributor services. Some companies use ways to provide after-sale services without creating free riding opportunities.

First, some manufacturers centralize the after-sale services and provide them on their own instead of locally through authorized distributors. This may not be the most cost-efficient solution and can increase the gap between customers and manufacturers, since the local distributor may have better information on local tastes and behavior of customers.

Alternatively, some companies unbundle the goods from the services letting consumers purchase after-sale services from the most competitive supplier. The problem with this scheme is that companies that base their products' attractiveness on their services loose that competitive advantage. In addition, unbundling services from products usually develop markets for the repair of the product. Independent service companies will not take in consideration the harm to the manufacturer's brand when they perform poor services. Consequently, a less informed consumer will not be able to differentiate the poor quality of the product from the poor repair service. A third approach some companies adopt to avoid free riding in the after-sale services when dealing with gray markets is to inform consumers that product purchased outside their authorized distribution system will not have its warranty honored by the authorized distributor. This strategy can create a big damage to the company's brand since the company is denying the quality assurance of its own product. Moreover, competitors may find an opportunity to increase market power using marketing campaigns to reinforce their quality assurance and services guarantees.

The introduction of less expensive brands in low-price countries and the sales and channel management are other practical techniques companies adopt when battling gray markets. Some companies may find a solution to international pricing problems by

29. Journal of Health Care Marketing (Fall 1995)

introducing different brands in high-price, high-income countries and in low price, low-income countries. This would make the products less suitable for arbitrage, and much larger price differentials could be established. Of course, this influences any advantages of economies of scale and global branding. A conscious tradeoff has to be made in these cases. In many instances, large manufacturers find it cheaper to franchise the production of their name brand products to local producers rather than to have these goods shipped directly from another country. The product is usually the same, and the biggest difference is the packaging, which may be adapted to the local market. For example, Intel launched a program to sell microprocessors in shrink wrapped boxes to better control quality and distribution[30].

Back to the case of pharmaceutical industry, another fertile source of diverted medical products is in goods intended for export. Despite the deep discounts granted the largest hospitals and groups, many manufacturers offer even lower prices to foreign buyers. In order to assure these bargains aren't shared with domestic customers, manufacturers employ elaborate security measures, separate distributors and even different (non-English) packaging. Since all these diversionary activities threaten the ability of manufacturers to discriminate in their pricing, they must employ yet another tier of administration to audit and investigate the widespread practice. Other firms have gone further than just changing the packaging of their products. They have actually made small changes in the product itself, in order to make it perceivable by consumers and to exploit the differences in standards from different markets. For example, a computer assembled with the keyboard using Chinese characters or a photograph film that doesn't fit cameras sold in the U.S. make it almost impossible for a consumer to use these products in other foreign markets. Of course, these solutions come with the loss in scale of production trade off.

As mentioned before, a number of progressive companies are taking advantage of the changes in the market in order to establish more efficient sales and channel management practices. For example, Lotus Development Corporation in software and IBM in personal computers, which encountered gray markets for their products, responded by refusing to sell to some resellers[31]. By bypassing existing distribution systems in order to reduce its costs in response to the threat posed by generics and parallel imports, Monsanto recently took the bold step of bypassing its complex and costly distribution system[32]. Despite operating in the agricultural market - one of the most traditional in Japan - where strong relationships are often the key to success, Monsanto broke its ties with its distributors and linked up with a stronger partner. It reduced its distribution costs significantly and expects to see its market share rocket thanks to the more direct contact it now has with end users. As the first company in the industry to restructure its distribution system, Monsanto took a

30. Computer Reseller News January 27, 1997
31. Cespedes (HBS case 9-586-124)
32. McKinsey Quarterly (1995)

huge risk, since it was dependent on distributors for all functions except marketing. To limit this risk, the company rigorously assessed both the consequences of dropping its existing partners and the capabilities of potential new partners. It also made detailed plans showing how it would use outside specialists to replace the functions lost through restructuring.

However, in developing their own anti-gray market strategies, manufacturers should bear in mind two aspects: first, the detection technology and second, the level of protection to trademark rights versus to patent rights. The detection technology may employ a mix of market sampling and dealer auditing, in the sense that it triggers investigations of dealers whose products show up in the gray market, and employs audits of dealers either as a result of suspicion of participation or as a routine matter. Some companies use consumer response cards, typically filled out to establish warranty protection, which are checked for the source of purchase. Other source of information may be other dealers' complaints about a particular dealer activity. Serial numbers of product resold by unauthorized dealers are tracked back to the sources that made the resale.

LEGAL ASPECTS

Early attempts of companies to face gray markets were based in the hope of legal protection from trademark laws. I now approach this issue and try to show the problems of companies relying only on the illegal aspects of parallel importation to defend themselves against gray markets.

Trademark law is the most common legal approach to parallel importation problems. However, there is an ongoing debate about the legitimacy of gray goods. The debate incorporates a more general question regarding the purpose of trademark protection laws: is trademark legislation intended to protect the trader or the consumer? One line of thought considers the basic motive of such legislation to be to prevent the public from buying the product A believing it is product B, or to prevent misleading advertising or false description of goods. Others argue that trademark protection laws are intended mainly to protect loss of goodwill by the trademark owner or a licensee. The first approach believes that if a parallel import is identical to the product imported by an authorized dealer, no consumer confusion exists, and the gray good should be perfectly legal. If the product is not totally identical, whether in its physical form on in terms of accompanying services, the import would still not constitute a threat to the trademark's value, provided the public has been warned about the differences. The second approach believe that the entry of gray goods should be barred in all circumstances because of the damage of the goodwill suffered by the trademark owner through the "free-riding" effect I have mentioned before.

Most parallel importation cases involve trademark litigation. Law and economic theorists argue that the reason for trademark protection is to promote economic efficiency in

two ways: by reducing consumers' search costs via facilitating and enhancing consumers' decisions and by creating incentives for manufacturers to produce goods of high quality[33].

Consumer search costs are reduced when trademarks identify the source of the trademarked good and consumers are able to associate the mark and its features to their previous experiences or information. In addition, consumers assume that goods bearing the same trademark are of the same quality and therefore, they can extend their experiences with the guarantee function of other products of the same trademark. Moreover, consumers are exposed to information advertisement that is connected to the trademark. These advertisements provide information about the existence of the product, the specification of the product, prices, location of stores, opening hours, etc. This information reduces the uncertainty about the product and can reduce the consumer search costs.

In the macroeconomic analysis level, there is no consensus about the gray markets effects or on how a desired legal approach in gray market cases should be. Cho (1992) argues that there is no justification for obstruction of gray markets, since the gray markets imports can increase the total domestic welfare of a country by providing more efficient sources of imports and by promoting domestic competition among agents. Rubin (1993) argues that parallel import is a function of international price discrimination and hence, if such pricing is welfare enhancing then legal action should be provided to prohibit parallel import.

Some defenders of the gray market argue that diverting fills an essential role in the economy since it allows consumers who would normally not be able to afford a luxury product to acquire it. In addition, in some industries, it prevents distributors from creating false shortage situations, which would allow them to maintain artificially high prices. Proponents of the gray market also argue that classic free trade theory gives consumers the right to the widest selection of products at the lowest prices. Without gray market imports, local distributors face no intra-brand competition and can charge monopolistic prices. On the other hand, opponents argue that gray market goods cause consumer confusion and compete unfairly with the established goodwill of authorized distributors.

Many arrangements exist through which gray market goods may enter a country, and the legal recourse for the trademark holder varies with each arrangement and from country to country. In the US, most parallel importation cases involve an attempt to utilize the customs regulations to prevent the importation of gray goods into the U.S. In the fragrance industry, for example, manufacturers once requested customs regulators to seize shipments of fragrances reentering the country. They claimed that gray marketers, by bringing the product back into the country outside the chain of authorized distributors, were violating their patent rights on the product. The gray marketers maintained that they were simply filling a need and helping more consumers to buy the product. A more successful

33. Landes and Posner (1987)

issue on which manufacturers have attempted to stop diverting is copyright protection. Manufacturers can trademark the packaging of products and can sue to prevent gray marketers from selling products enclosed in trademark-protected packaging.

The U.S. Customs Service and the courts have usually held that parallel importing is a lawful practice. According to legislators, the fact that the foreign manufacturer doesn't like this parallel competition and doesn't "authorize" importation of its products by other firms, does not make this practice improper or illegal. This is not a standard, however. Some foreign manufacturers have convinced California judges to deny American consumers access to lower-cost parallel imports because they violate the U.S. copyright laws. As a conclusion, the debate surrounding the legitimacy of gray goods is still based on the fundamental question concerning the purpose of trademark legislation, or whom should it protect. To the consumers' point of view, their preference is still for the existence of cheaper products, even with lower levels of service.

SUMMARY OF CHAPTER 2

In this chapter, we were discussing the impacts of gray markets on global organizations. Focus was on the international dimension of pricing management and its consequences. Initially, emphasis to the firm's pricing strategy was given, since this is the most relevant determinant of a firm's ability to respond to gray markets that are fostered by price differentials. Then a discussion over global pricing strategies was presented and how the pricing flexibility of a firm is important to provide a fast response to price international differentials. The level of vertical integration of the firm, its organizational structure, and the exchange rate are the most important constraints that influence the firm's pricing flexibility. The reader also saw that firms that deal in international markets would tend to price discriminate and take advantage of the different purchasing disposition that consumers have in different markets.

The level of difficulty for firms to price discriminate in global markets and how price discrimination facilitates arbitrage and gray markets was introduced. Pricing bandwidth can reduce, but not eliminate, the vulnerability of the firm to the gray market and companies that continue to price discriminate in international markets are facing and resisting the parallel import of gray goods by using different practical methods. Finally, a simple outlook on the legal aspects was presented and how the trademark protection influences the ability of firms to deal with gray markets. We can conclude from Chapter 2 that there isn't still a recognized method that permits firms to fully take advantages of international consumers' differences, when setting their pricing strategies to avoid gray markets.

CHAPTER 3

THE CASE OF TECHDISK

In this chapter, the case of gray markets in a company named TechDisk is presented, starting with a company overview. Then, a brief history of the problem and an explanation of its impact and consequences in the company's operations are provided. I explain how the gray market scheme operates in TechDisk using my assessment about the sources and destinations of gray products. I also explore some of the organizational and managerial factors that have empirical correlation with gray markets. I finally relate how TechDisk has been reacting to gray markets.

COMPANY OVERVIEW

TechDisk started its operation in the early '70s, developing computer peripherals, such as floppy disks and CD ROMs. TechDisk prospered during that period, developing a number of different markets for its products. TechDisk has been recognized for the innovation of its product line and has developed a strong brand in the U.S market. As part of the company's expansion program to foreign markets, the opening of European markets, particularly the demand for CD ROMs increased sales in that region in the early 1990s.

TechDisk is a leader in the computer peripherals and sells millions of packs of floppy disks per year. TechDisk hopes to grow by focusing on two essential areas. In its core consumer business, the company is enlarging its advertising efforts in North America, Europe, and Japan. It is also making advances in 11 fast-growing foreign markets, including Brazil, China, India, and Poland. In its commercial segment, TechDisk has sharpened its focus to selected high-growth segments such as the professional and technical markets.

TechDisk sells its products worldwide. Its primary office and manufacturing facilities are in the United States, with other manufacturing facilities in Mexico, the Netherlands, and in the U.K. Roughly, half of TechDisk's revenues come from overseas. In 1994, for example, TechDisk recognized $150 million in sales in Russia, $30 million in sales in China and $7 million in India. In 1996, global sales reached $2.3 billion with 47% and 29% of these sales coming from the U.S. and the European markets, respectively.

THE GRAY MARKET PROBLEM IN TECHDISK

A background on the problem is presented, followed by an assessment of the organizational and managerial factors relevant to the gray market problem in this organization.

Background

Many years ago, TechDisk decided to expand its operations to global markets. TechDisk managed to penetrate a series of new international markets by adding indirect distribution channels to reach these new markets. This included emerging markets such as Russia and China. As a consequence, the popularity of TechDisk's products in such markets has been contributing significantly to the company's financial results and represents the importance of the operations in those countries. For example, in 1996 sales in the Asia Pacific, Canada, Latin, and South America regions as percent of global sales, increased to 29% in comparison to 23% in 1994.

In addition to the penetration of new markets, after 1994 TechDisk took significant steps to refocus its core business of computer peripherals in the established marketplaces of the United States, Japan, and Western Europe. TechDisk also expanded its presence in emerging markets. At that time, the company repositioned itself by focusing on reduction of expenses, operational efficiency improvements, and market growth.

To implement that strategy, in Russia, for example, TechDisk began expanding the distribution of CD ROMs from its original base in Moscow by adding distributors based in other major cities. TechDisk's brand recognition in Russia is high and Russia remains among the company's largest market with a good prospect for the future. In China, aggressive sales and manufacturing expansion continued, leading to double the sales since 1994. In that country, new sales offices, a new subsidiary and a broaden distribution system were implemented in 1995. China remained a pivotal manufacturing site for TechDisk in the Asian Pacific region. TechDisk also continued to establish its presence in Vietnam, gaining full distribution throughout the country.

Since international sales have accounted for an increasing share of TechDisk's worldwide sales since 1995, in 1996 TechDisk adopted an even more aggressive expansion strategy in developing markets. Their tackled eleven high-priority countries - including China, India, Indonesia, and Turkey - simultaneously with very positive growth results in sales. In these countries, basically supported by its brand recognition, TechDisk was typically targeting the consumer segment for establishing purposes. One characteristic of these emerging countries was the small-established infrastructure for product distribution in most of them.

Although some regional gray market might have been occurring in TechDisk's activities within the U.S. in the past (there is no evidence of that, despite some reports from the U.S. Commerce Department addressing the gray markets early stages to the 1980s), international gray markets have not been perceived by the company since several years ago. We can assume that, based on the requisites for gray markets explained in the section 1.2.1, the international gray market at TechDisk has appeared jointly with the

expansion to worldwide markets. However, there is no evidence that parallel imports are consequence of the extension of activities to emerging markets. Although TechDisk had been expanding to global markets for some time, only in 1992 TechDisk started to perceive the real presence of the gray market in the company's operations. At that time, most of its manifestations were through parallel exports from the U.S. to other countries, especially Japan and Western Europe. In 1994, for example, when TechDisk started operating in the Russian market, many complaints from Russian distributors demonstrated that the problem was getting more serious and complex. Management believed that the major contributors for the parallel export were the exchange rate and a "bubble" of consumption in Russia.

Globally, gray markets have been affecting TechDisk in two major product lines: floppy disks and CD ROMs. Their major problem is perceived on the commercial consumers segment, such as software distribution companies, who are more price sensitive and buy in bulks. These customers do not care much about the origin of the product once they get a lower price.

The actual stage of gray markets in TechDisk shows that parallel importation of TechDisk's products from all over the world into several high price markets has been increasing for some time now. The company has been suffering from difficulties to manage the damages that parallel importation has caused in TechDisk's pricing policy. In addition, tension and irritation among participants of the company's distribution channels is bringing the problem to the managers' increasing concern.

The Flux of Gray Products

At TechDisk, they have been trying to trace the route of gray products in its distribution channels, but the low efficiency of the tracking system is a major problem to identify the sources and destinies of products. Recent tracking of divested products shows that major sources of gray products are mainly China, Korea, Singapore, Vietnam, and Mexico. These products are directed to some very attractive markets, such as the US, Germany, Japan, and Brazil. In the U.S., the principal import channels are some large wholesalers from the northeastern region. These large dealers (authorized or not) supply many big consumers and small dealers, who supply the smaller end users.

As an example, prices in China are usually 30% cheaper than in the US. Wholesale prices may vary from $5 in China to $9 in the US for a standard pack of CDs. China manufactures the CD ROM (what TechDisk calls the "integral product" - one of the most affected by gray markets) and that CD is sold for $5.95 per pack in China. That pack will get to the wholesaler for $7.25 in the US. This big dealer sells the film to smaller dealers for $9.25 against $9.74 charged by TechDisk. This wholesaler also sells to other big end users for prices up to $8.00 per pack. According to TechDisk's management, this price is usually undefeatable when faced with regular prices or even promotion prices. Another

examples are packs of CDs imported from Puerto Rico, sold for $14 versus $$20 in the US. It is important to emphasize that on a $ 10 pack of CDs, TechDisk will compute a gross margin of up to 60%.

According to TechDisk's managers, gray market wholesalers typically need less than a 50 percent price differential to exploit the arbitrage opportunity. There is no explicit lower price limit for gray marketers to enter or leave a market. "Once they can cover their transportation costs, several steps of profit margin and import duties, they are active", says one manager from TechDisk. According to that manager, the Chinese price example would need to be pushed above $8 to prevent the gray market.

However, sometimes the "sales push" in the U.S. or in other developed country can change the flux of divested shipment. This can happen when some TechDisk's business units are "struggling to make the numbers". To meet their quotas, management from these units increases the discounts that bring prices down and open windows of opportunities for changes in the flux of gray products. In those cases, markets that are sources may become targets for gray marketers.

In order to get to know the level of intensity of diversion of products, TechDisk relies on two major sources of information. One is the indirect information of the wholesalers' activities, that comes from other wholesalers or from customers, that "tells them" which wholesalers are buying gray products and who are the sources. The other is the information derived from the sales departments, that monitors abnormal volume of orders and sales from wholesalers, signing that some product may being divested. Some of these dealers are tracked by the volume of their contracts with the big end users such as the software companies and large-volume consumers.

TechDisk also monitors the bidding for large orders from big commercial consumers and other regional contracts. By getting to know who wins the bid, the prices charged and volume offered, they can infer if the products come from parallel import once they compare volumes with historical sales data. However, the identification of countries sources is very difficult in many cases. It is only possible to identify sources when the product packaging is different, or the product's bar code has been tracked. But even in such cases the identification of the distributor responsible for the channel leakage is very difficult and heavily dependent on third parties' information. One interesting issue about the sources of information of gray market activities at TechDisk is the negotiation aspect that it is sometimes exploited by gray marketers. Some authorized distributors, which participate in the gray market channel, actually assume that they can buy and sell divested products. Basically, these distributors use this information as a bargaining power to get better product offers from TechDisk.

Organizational and Managerial Factors

In previous sections, I explained basically how the gray markets occur at TechDisk. Using a more macroeconomic view, I showed how the flux of gray products is characterized and how TechDisk's international expansion program can be correlated to the increase of activity of gray markets. In this section, a more microeconomic outlook of the company internal practices and how those practices relate to the gray market problem is presented. The influence of the pricing strategy, the distribution system, and the management attitude on the level of intensity of the gray market activity is discussed.

Pricing Issues

TechDisk's pricing strategy requires international markets to have different prices as consequence of differences in the local purchasing power. Pricing and purchase criteria for the consumer market and the commercial market products differ depending upon the end-user application. In addition, the market program is not the same for all the countries. Although there is not much differentiation among products by regions, marketing campaigns and advertising are localized via tailored distribution and market plans. The organization of the foreign markets include regional general managers (managers for each of the four regions TechDisk divided its international business in the world), local country general managers and local sales force. The sales force typically has little price flexibility, but the country manager has more flexibility to change prices, although not much. Prices are set by the head (general manager) of the market region. The "Americas" region, for example, has a bandwidth in which the price can fluctuate. Out of that band, however, the responsibility for pricing is moved to the head (president) of the consumer or the commercial business.

TechDisk does have a central pricing office that has the responsibility to track prices in different markets and report any major pricing changes. However, they are not always aware of price changes. The information is available on demand, although it seems like the information provided by this office has little influence on price setting. One reason for that could be the time lag to update and compare the worldwide prices on a single currency basis, which does not guarantee reliable information. In addition, prices are monitored by the organization via financial reports. They also have a monthly price report that allows the organization to know the worldwide prices. However, these reports do not show the localized "bottom line" prices (taken after all local promotions and deductions). Consequently, it is very difficult to make pricing decisions based exclusively on the reports. Nevertheless, even though they recognize the lack of better information to base pricing decisions upon when dealing with the gray markets, the possibility of adopting a centralized policy for pricing - a worldwide price - is not supported by the management.

Setting the wholesale price typically involves identifying a target retail price and working backwards to subtract out retail and wholesale margins. TechDisk does not set the retail price. Prices in the retail are consequence of the factors of competition among retailers. TechDisk has a suggested retail price list, which serves usually as reference for discounts and promotions, but seldom is applied to the end consumer.

TechDisk does not apply price discrimination to different distributors. Within the same channel, prices are similar. However, there are rebates and promotions discounts that can bring the price down for some distributors. These rebates are consequence of costs savings that are passed to the distributors. These costs savings are due when a distributor is considered a "Strategic Partner" or when TechDisk realizes some advantages, such as allowances for centralized shipment. There is not an explicit minimum order requirement for a reseller to qualify for a discount, however, come conditions apply for a reseller to have access to these discounts. Gray market activity also varies with currency fluctuations and short-term price changes. These price changes may be in response to end of quarter sales goals. There is a tendency to more gray market activity at the end of sales quarters, according to managers.

Distribution System

TechDisk uses a mix of direct sales and indirect channels. Direct sales are concentrated to a small number of customers that are served by TechDisk's sales force. These customers represent traditional high volume end-users that have been historically attended directly by TechDisk. The indirect distribution system can be basically divided into Wholesalers (or Redistributors) and Large Dealers. Distributors are chosen based on financial conditions, expected volume sales, geography, and access to niche markets, among other factors. The wholesalers supply the distribution channel compounded by small dealers, such as small supply stores. The large dealers supply the large end-users, such as state contracts and local government contracts.

TechDisk strengthened its approach to developing markets around the world by concentrating on markets with high growth potential. While relatively new, this part of the business has grown steadily since the 1990s, fueled by tailored strategies for manufacturing and distribution, customized product offerings, tariff reductions, and targeted pricing campaigns. In emerging markets, legitimate distributors can be a big help in growing the market. However, lack of established marketing infrastructure gives TechDisk two alternatives. One alternative is to vertically integrate in the distribution - an alternative that TechDisk has generally not chosen. The other one is to use a multi-layered system of independent distributors. These tend to be small, wealthy and highly entrepreneurial firms. In these markets, it is hard to distinguish legitimate distributors from gray market wholesalers, who tend to be very sophisticated, financially strong, and well informed about

prices.

Usually, TechDisk's big retailers, such as Kmart and Walmart, do not care much for participating in the gray markets channel. Basically, because they believe that there is no guarantee of a steady source of supply in their level of demand. In addition, they do not get the advantages of a centralized advertisement and promotion center. Consequently, TechDisk centralizes their attention on the channel leakage. The problems are focused on some authorized wholesalers, who practice gray market and supply contracts to commercial consumers. These distributors do not care much about TechDisk's threats of penalties, since they rely on other sources of supply to attend their demand. Apparently, the size of the distributor does not relate to the intensity of gray markets. The gray market activity is tolerated in the small dealers' accounts. According to TechDisk's management, the big problem arises when the wholesalers involved in these small accounts open a channel of supply to the large end-users. In these cases, strains in the distribution channel are frequent because the large dealers are responsible for the volume sales, which are usually very massive, to these large end users.

Management Attitude

The country management's compensation package includes rewards based on results (profits). The sales force is typically rewarded on revenue and margin. Revenues are based in sales quotas, which are based on targets for orders booked as well as sales for new accounts and sales of new products. This is an important aspect in the study of gray markets since sometimes managers' attitudes can foster the parallel trade. We have seen that there is evidence of more gray market activity close to the ending period of sales quotas. One can believe that the management response and incentives to meet sales quotas might be influencing the problem in an ambiguous way. While sales are increased when quotas are achieved, pressure for sales and promotion to meet those quotas may be increasing the gray market activity as well. As we saw in section 1.2.1, the management inertia and the management incentives can strongly contribute to maintain gray markets activities. According to managers, it is very difficult for TechDisk to require the wholesaler to buy from authorized sources only.

However, management attitude towards combating gray market in TechDisk has been changing. The problem is not seen as the "Marketing department problem" anymore, but as the "company's problem". Although there is not yet a formal structure responsible for the planning of actions to combat gray markets, some managers were assigned to deal directly with the problem. In addition, some structural changes are on the way, such as changes in the executive incentive program to reflect any agency behavior from managers. These actions demonstrate that TechDisk is working intensively in the problem.

How TechDisk is Reacting to Gray Markets

There is no history of termination of distribution contracts in response to dealers' activities in the gray market, although the dealer contract explicitly forbids parallel trading. However, some actions have been taken to reduce the intensity of gray markets. A response from TechDisk, for example, was based on promoting low prices to large dealers in order to give them some leverage, when competing with gray marketers. In 1997, TechDisk dropped the price to reduce the volume of inventory and punish dealers that had stocked gray products. In addition, TechDisk has used warnings to intimidate distributors who deal with gray products, though those warnings have had no effect so far. Surprisingly, a major source of penalization for those distributors has been the end-user, who sometimes refuses to accept the gray product and forces the dealer to bear the costs of reshipment and carry on the bad reputation.

TechDisk does not assume costs of reshipment of gray products. The distributor is responsible for all costs, including warranties. However, lack of warranties for gray products do not make much difference. Usually, retail consumers do not care much whether the CD is warranty covered or not. Commercial consumers, the big portion of the gray markets' targets, are very confident that TechDisk will honor the guarantee and change the pack of CDs if any problems arise. Although TechDisk alerts that there is no guarantee for gray products, the bottom line is that TechDisk maintains the guarantee and exchanges products originated from parallel distribution.

Most of the customers do not care about the packaging. They intuitively know that TechDisk guarantees the product, even if it is diverted. Lawsuits over distributors have had no effect so far. TechDisk knows that Kodak, some years ago, was having problem with gray products and cancelled some professional dealerships, which seemed to have worked so far. TechDisk, however, does not intend to do so.

In 1995, TechDisk started a battle with some parallel importers, which were underpricing TechDisk's products. TechDisk cut the discounts it used to give them. As a result, many angry gray market distributors worked off their inventory rather than placing new orders that year, hoping that TechDisk would reinstate the discounts. That cost TechDisk an estimated 12 million in sales. Nevertheless, TechDisk's intention when cutting retailer inventories was to reduce shipments of CDs to other geographic markets, to reduce shelf life, and to improve realized prices to TechDisk. Effectively, what was happening was that TechDisk's gray market dealers were ordering more product than they themselves could sell and then reselling the excess overseas, making a profit off the discount TechDisk was offering them.

We have seen in section 3.2.2 that monitoring gray market activity is difficult. It is sometimes possible to track the quantity of CDs shipments into a market and use this as

an indicator for the demand. TechDisk does this by evaluating the historical shipment and orders larger than usual. They could perform a more refined tracking system to find out the origin and the dealer responsible for the shipment, but the high volume of shipments does not allow that. The existing tracking systems help them to identify the source, but not the dealer. Once a dealer is found shipping to unauthorized markets, TechDisk warns the dealer about terminating the contract.

The management is reconsidering its global pricing strategy and is starting to make some radical adjustments. They are thinking about reorganizing international pricing towards a higher degree of coordination and centralization. For example, in 1998, they intend to initiate a minimum pricing system - global, that prohibits the price to go below a certain limit anywhere in the world. According to that plan, some countries, the ones that have better control over parallel exports, may have some exceptions. There will be exceptions for some products as well. The problem to implement this system is that they cannot track efficiently the price changes in other markets. This is an important issue since the monthly price reports just reflect the "above board" prices, and do not capture special promotions and rebates used by some countries. In addition, they have no answer regarding how they will solve the problem of giving flexibility to the sales force to set the prices while maintaining the minimum price system. Another important issue will be how to manage the interface between the pressure for quotas and the minimum price system, which will reduce the country managers' ability to use pricing strategies to achieve quotas.

As to the management attitude, TechDisk is thinking about assigning more responsibility to the country manager that cannot control the outflow of gray product. The idea is to reflect the gray product sales in these countries' financial statements, reducing the gray market-based profits and consequently the results-based incentives. There is an increasing credible threat of termination for the sales force (and even for the country manager) if these are caught knowingly or recklessly supplying gray markets. Some people have already been fired in the past.

For TechDisk, the essential root of the problem is the source of diverted products. They intend to control the source of gray product via two alternatives: changing the product or changing the product's packaging. In China, for example, they are changing the packaging format, differentiating from Western packages. This solution will apply only to China for a while. In addition, TechDisk started a marketing campaign to educate the consumer about gray markets, betting that the US consumer will understand the difference, and avoid diverted products. However, in the past, they experienced some problems with some gray marketers who changed the packages to hide some indicators of origin. TechDisk still does not know how to deal with this specific problem.

SOME COMMENTS ON CHAPTER 3

This chapter described the case of TechDisk, a company that is quite aware of how the gray market impacts its sales and distribution schemes. We have seen that gray markets activities in TechDisk started to be relevant when they expanded their operations to international markets. However, there is no clear pattern of the flux of gray products from and to different international markets. Depending on the price differentials, the flux of gray products can invert. In the case of TechDisk, these price differentials can be provoked by exchange rate fluctuations or by the company's own pricing policy, especially when some of the TechDisk's markets have to increase sales to meet the quotas.

Top management at TechDisk is concerned about the impacts of gray markets on prices and revenues and the impacts on the distribution channel (TechDisk has received many complaints from their distributors). We have seen that TechDisk is trying to control the flux of gray products in its distribution channels by differentiating the products' packaging among markets and by increasing monitoring on the flux of divested products. Another solution that they are analyzing is the differentiation of products, which can be very effective if it can avoid interchangeability of products in different markets. However, as I mentioned before, product differentiation comes with the trade off in the scale of production and there is also the issue of the dominant design for products such as CDs. If the differentiation is done mainly in the packaging, TechDisk has to assess the sensitivity of their consumers to differences in the packaging. TechDisk needs to use that differentiation to communicate to the consumers their message about the consequences and risks of buying gray products (deterioration, loss of guarantee, etc). Consumers must be informed of the explicit role of the guarantee. Monitoring gray market activity is a very important task. Although TechDisk does monitor trends in international prices for their products, it seems that they have not developed a method to monitor international price differentials efficiently, rapidly enough to respond with the preventive actions to control parallel import.

In addition, TechDisk is planning to adopt a minimum price system, or the pricing scheme within a bandwidth (the "price corridor"). However, it is not clear how TechDisk will set the corridor limits, or whether TechDisk will adopt the corridor for all the markets that they have distribution channels. Alternatively, how they plan to develop a pricing database to support the new pricing system is another important issue. As we discussed in 2.1.3, an international price corridor may work fine in controlling parallel import. However, it is imperative to develop a reliable global pricing information system from which TechDisk's managers can gather and analyze data and make the decisions.

Regarding the distribution system and the relationship of TechDisk with their distributors, there is not a clear statement of consequences from TechDisk to the members of their distribution channels, which deal with gray goods. It seems that the company is still trying to find the right measure to deal with this issue. This is reasonable in the sense that

it is not completely quantifiable to TechDisk how harmful gray markets are to the company. TechDisk's top management team is concerned and committed to face the gray market problem. However, for the country managers that are trying to maximize their sales and achieve their quotas, gray markets may be a secondary concern.

CHAPTER 4

CONCLUSION

This study attempted to elaborate on the new, yet complex issue of gray markets. The gray market is effectively a lighter shade of the black market, where the goods are not illegal but the method by which they have been acquired is unorthodox or unlicensed. Diverting is a fact not only in the U.S. economy, but in many global economies. It succeeds because it fills a need for the public. Without the gray market, many products would be prohibitively costly and, perhaps, unavailable to many consumers. What is more, the manufacturers of these products tacitly help gray marketers by producing and selling more product for some markets than that market can absorb.

Manufacturers cannot claim they do not know what is happening to their products. Most of these producers are tremendously sophisticated worldwide giants that have done vast amounts of marketing and product research. There are always two sides to parallel or gray trade: an exporter for whom trade is very attractive, and an importer whose sales are cannibalized and who has paid for the marketing upfront. In the company's point of view, passivity can be dangerous. While headquarters may be relatively neutral in this battle, it should not be passive. Hostilities can develop between country subsidiaries because headquarters adopt a passive role. This issue requires the attention of top management.

In the author's point of view, the objective should be to maximize overall profit, not to eliminate parallel imports. A certain, usually small, amount of parallel imports can be tolerated if it allows better profits in the individual countries. In many cases, the number of parallel imports is small but the effects on perception and price negotiations are large.

The author concludes that, nowadays, it is an illusion to believe that a globally identical brand can be sold in different countries at prices that differ substantially relative to costs of arbitrage. This problem has been largely neglected by managers of global companies. A global product and local price are incompatible in a world of less barriers for trading. One answer to international pricing problems may be to introduce different brands in high-price, high-income countries and in low-price, low-income countries. This would make the products less suitable for arbitrage, and much larger price differentials could be established. Of course, this runs counter to economies of scale and global branding. A conscious tradeoff has to be made.

Many international pricing problems arise because a company does not know its positioning in various countries. Take for example the case of a large manufacturer that grew mostly through acquisitions. Its position in some countries is at the lower end of the price scale; in other countries, at the upper end. Some subsidiaries want to build market

share and price aggressively while others are market leaders, have high prices, and want no change. The company is struggling with internal international conflict. In these cases, the most viable solution lies in reconsideration of the international positioning strategy and a reorganizing to make strategy and structure consistent.

We have seen that TechDisk is one, among many global companies, that is working on the gray market problem. The solution is not easy and may come with some unpopular measures to build the management commitment to solve the problem. Supported by a good information system and channel management, the company may not be able to eliminate it, but may be able to control the gray market activity. This study leaves some gaps for further research. Questions about the quantifiable level of damage of gray markets to the companies, to the consumers and to the countries' economies still need to be better assessed. Yet, international pricing is a mystery for many companies. In that field, the issue of using a "price corridor" or other pricing strategies that permit companies to fully explore their products' competitive advantages in international markets need to be broadened to the practical level. Finally, what the level of interference of governments in regulating international trade and parallel imports should be, or how the law should interpret the trademark rights in cases of parallel imports, are questions that remain to be deeply evaluated.

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